NGA Center for BEST PRACTICES

Issue Brief

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STATE STRATEGIES TO ADDRESS FORECLOSURES

Executive Summary

Many factors have shaped the recent spike in subprime mortgage foreclosures, including climbing interest rates, falling housing prices, financially overextended buyers, nontraditional mortgage products, speculation, and predatory lending practices that jeopardize the ability of homeowners to pay their mortgages. This *Issue Brief* examines current and proposed state actions that address challenges in the subprime lending market, help families avoid foreclosure, and prevent predatory lending practices.

During the first quarter of 2007, the percentage of home mortgages entering foreclosure reached its highest point in 28 years. An estimated 2.4 million borrowers with subprime home loans originated between 1998 and 2006 have already lost or will lose their homes to foreclosure.

Foreclosures often cluster in certain neighborhoods, particularly those that are predominantly low-income or minority. Multiple foreclosures in a community can lead to lowered property values, crime, and the deterioration of property, which can cut into a state's tax revenues.

States have a long history governing mortgage lending and foreclosure practices through statute and regulation. States are well-suited to reach out to troubled borrowers to help connect them with the resources necessary to either avoid or mitigate the impact of foreclosure. In response to the recent wave of foreclosures, state policymakers are tailoring initiatives to meet the needs of their citizens and the challenges they face, including:

- Protecting consumers from foreclosure "rescue" scams;
- Connecting borrowers to counseling and resources;
- Facilitating workouts and refinances by working with loan servicers and establishing foreclosure prevention funds; and
- Slowing the foreclosure process.

At the same time, states are acting to prevent future foreclosures by:

- Banning common predatory practices;
- Adopting regulatory guidelines for subprime and nontraditional mortgage products;
- Tightening regulation of mortgage brokers and loan originators;
- Increasing criminal penalties for mortgage fraud, enforcing existing lending laws, increasing funding for supervision, and pursuing violators; and
- Educating homebuyers.

States are using the above strategies to prevent unnecessary foreclosures while working to preserve homeownership and the availability of financial options for low-income residents.

Introduction

From January through June 2007, more than 530,000 families in the United States saw their "American Dream" slip away.[1] During the first quarter of 2007, the percentage of home mortgages entering foreclosure reached its highest point in 28 years, affecting roughly one in every 172 home loans. This rate continued to rise during the second quarter of 2007.[2] By the end of the first quarter, the housing market had waned. Home sales dropped 30 percent below 2005 rates, and median housing prices declined by 3 percent, leaving many homeowners unable to sell their properties.

The rise in foreclosure is partly due to growth in subprime mortgage lending—or lending to consumers with less than stellar credit. In consideration for extending credit to higher-risk borrowers, lenders impose higher interest rates and more costs or fees on subprime loans than on prime loans. In 2006, subprime mortgage originations comprised 20.1 percent of the $3 trillion mortgage market, and in the first quarter of 2007, they accounted for 54 percent of all foreclosures.[3]

Low- to moderate-income families and those with blemished credit histories can benefit from subprime mortgage products because these mortgages provide them access to credit and help them achieve homeownership. However, climbing interest rates, falling housing prices, financially overextended buyers, nontraditional mortgage products, speculation, and the susceptibility of subprime borrowers to "predatory lending"—the practice of originating loans with unfair terms, often through deceptive means—have compounded to place many subprime borrowers in financially tenuous situations.

First American CoreLogic estimates there will be 1.1 million subprime foreclosures by 2014 due to borrowers unable to make increased monthly payments on subprime adjustable rate mortgages. The Center for Responsible Lending (CRL) expects this trend to be even worse, predicting that 2.4 million families with subprime home loans originated between 1998 and 2006 have already lost or will lose their homes to foreclosure, costing families as much as $164 billion. CRL further predicts that 19 percent of subprime mortgages originated since 2004 could end in foreclosure. At the end of June 2007, more than 20 percent of subprime loans were past due.

States have historically provided consumer protections to help families obtain fair and affordable mortgages by enacting laws that protect against usury, mortgage fraud, and predatory lending. To curb the current national foreclosure crisis, state policymakers are reviewing and improving their existing laws to ensure they address the large number of subprime foreclosures while keeping financial options available to low-income borrowers. Since the beginning of 2007, states have launched foreclosure prevention funds, resource hotlines, and free counseling. To enhance regulation and accountability of the mortgage industry, more than 30 states have passed legislation to ban predatory lending practices, strengthen lender oversight, regulate mortgage broker companies and loan originators, and educate potential homebuyers.

This *Issue Brief* focuses on foreclosures in the subprime mortgage market, including those that may have resulted from predatory lending practices. It is divided into three sections:

- **How Did We Get Here?** – The first section provides background on the mortgage lending market and its evolution from restricting credit to overextending credit. It includes definitions of different mortgage loan products; explains the roles of banks, lenders, and brokers; and details predatory lending practices.

- **The Impact of Foreclosure on States, Neighborhoods, and Families** – The second section describes the effect of foreclosure on communities, including financial instability, crime, and local economic decline.
- **State Actions to Help Homeowners** – The final section highlights current state efforts to help troubled borrowers, prevent foreclosure, and curb predatory lending and describes actions governors are taking to keep families in their homes.

How Did We Get Here?

Before the advent of 30-year and 15-year mortgage products, potential homeowners who needed help financing the purchase of a home relied on short-term mortgage loans that required payment in full after a three- to five-year period. The post-Depression era began a transformation to higher levels of homeownership through the formation of the Federal Housing Administration (FHA) and the establishment of long-term, fixed-rate mortgage loans that are common today.

Since then, major legislative actions have helped to open up the mortgage market and extend credit to low-income families. In the 1960s, '70s, and '80s, federal fair housing laws addressed many challenges of access and affordability, such as redlining, or the practice of refusing loans to certain borrowers—often because of their race and income.

In 1977, Congress passed the Community Reinvestment Act, which required banks and lenders to help meet the credit needs of the communities in which they operated.[4] This act was intended to discourage redlining and help families achieve homeownership.

The passage of the Secondary Market Mortgage Enhancement Act of 1984[5] and the subsequent Tax Reform Act of 1986[6] led to the expansion of "mortgage-backed securities" (MBSs) into the private sector, beyond what was offered from government sponsored enterprises (GSEs) such as Freddie Mac and Fannie Mae (see box and chart on page 4).[7]

While these changes increased regulation and oversight of the prime market, the emergence of automated loan origination, selling, and servicing and the unprecedented availability of capital led to the growth of the subprime mortgage loan market under far less regulatory scrutiny. The subprime market extends credit to borrowers with less than stellar credit histories or unreliable income. The number of subprime loans originated in the United States has exploded since the early 1990s, with the share of subprime loans growing from $20 billion in 1993[8] to $332 billion in 2003.[9]

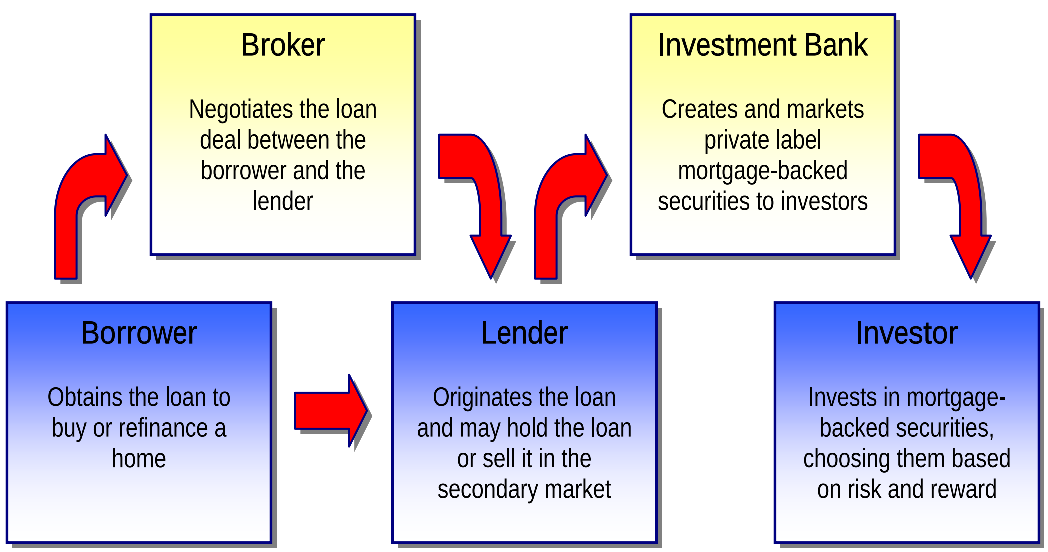
Responsible and fair subprime lending can help low- to moderate-income families achieve homeownership, which may be the single most effective tool for helping them build wealth and gain financial stability. Moreover, homeownership helps to both create and stabilize communities. Homeowners are more likely than renters are to invest in their properties and neighborhoods and participate in community and civic activities.[10] Thus, the financial and social benefits of homeownership make it a cornerstone of personal, civic, and economic growth.

The Role of the Secondary Market

Subprime lending has flourished in recent years because of interest in MBSs from major Wall Street investment banks and a process called securitization. Through securitization, lenders can sell their loans in bulk to the secondary mortgage market (the market where loans are bought and sold) at a profit. The secondary market consists of both GSEs like Freddie Mac and Fannie Mae—regulated by the Office of Federal Housing Enterprise Oversight (OFHEO)—and private investment firms. Investment firms bundle subprime loans (which are considered risky because of the borrowers' higher probability of default) with less risky loans for sale as bonds, or highly rated MBSs. Investment banks sell MBSs to individual investors, who may choose MBSs based on their preferences for risk versus return. (See the chart, "The Cycle of a Subprime Mortgage Loan.")

The housing boom helped drive demand for MBSs. Increased demand made loans to low-income consumers profitable and gave lenders the opportunity to reinvest earnings from MBS sales into other profitable loans. This demand opened the door for weak underwriting and fraudulent practices. Although securitization helps lenders to extend credit to a wider range of borrowers—including those with weak credit histories—by dispersing risk, securitization also makes it difficult for borrowers to restructure and refinance their loans. Many MBSs stipulate that only a certain percentage of loans within the bond may be restructured. If additional borrowers request restructures, a majority of investors must approve. According to Standard & Poor's, about three-quarters of subprime mortgages originated in 2006 were funded by securitizations.

The Cycle of a Subprime Mortgage Loan



Mortgage Lending Primer

The mortgage market has an abundance of new products designed to serve a range of borrowers. The following sections provide a basic overview of loan products, borrowers, and lenders.

Loan Products

The past five years has seen the expansion of nontraditional, or "exotic," loan products. Such products, which have traditionally been available to financially flexible borrowers to build equity or engage in entrepreneurial endeavors, have in recent years proliferated, driven by demand from the secondary mortgage market and investors seeking to profit from rapidly rising home values. However, such loan products can be a gamble for potential homeowners because a sudden market downturn can turn these products from profitable investments to financial liabilities.

Regardless of the loan product structure, borrowers are responsible for all components of the total loan balance. Traditional loan products, such as 15- or 30-year fixed-rate mortgages, set a minimum monthly payment based on principal and interest designed to fulfill the total loan balance by the end of the specified period. Alternatively, exotic loans do not have a fixed monthly payment or fixed interest rate. They allow borrowers to make smaller premium or interest-only payments early in the life of the loan and larger payments later. Borrowers also are responsible for property taxes and insurance premiums, costs that are typically folded into the monthly mortgage payment.

Exotic loan products include:

- **Interest-only loans** that let borrowers pay only the accrued interest on their loans for a fixed grace period, allowing them to make low monthly payments during that time. This type of loan comes with significantly higher payments after the grace period expires because borrowers must begin repaying the principal.
- **Deferred interest loans or negative amortization loans**, which allow borrowers to pay *less* than what they owe in interest and principal during a grace period. These loans have payment and interest rate adjustment caps, meaning that payments stay the same during the grace period even if the interest rate rises. This can increase rather than decrease the size of the loan. As with interest-only loans, borrowers can make low payments to a negatively amortized loan for a fixed period before the monthly payment rises.
- **Hybrid adjustable rate mortgage loans (ARMs)**, which let borrowers pay their loans at a below-market fixed interest rate for a set period of time, after which the rate resets to the current market rate and continues to reset throughout the life of the loan. These loans can be useful for borrowers who plan to sell their homes or expect their salaries to increase before their monthly payments reset.
- **Option ARMs** that give borrowers the option of choosing from different types of payments each month, including minimum payment—which may be less than the monthly interest, resulting in negative amortization; interest-only payment; fully amortizing 30-year payment; or fully amortizing 15-year payment.
- **Balloon loans**, which let borrowers make low fixed monthly payments for a short period, after which the borrower must pay off the bulk of the loan in a lump sum.

A component of mortgage lending that has become more common in the era of relaxed underwriting standards is the use of stated income rather than traditional asset and income verification. Stated income allows borrowers to certify their income without documentation. Stated income can help borrowers who have varied income, unreliable income, or difficulty documenting their income, such those who are self-employed. However, stated income also may result in borrowers gaining approval for loans they cannot afford. Stated income loans are often called "liar loans" because they give borrowers, brokers, and lenders the opportunity to falsify income information to gain loan approval. According to the Office of the Comptroller of the Currency (OCC), in 2006 almost 50 percent of all subprime loans also were stated income loans.[11] Although stated income loans do not always include falsified information, the increased use of stated income in loan applications is cited frequently as a key factor in the rise of foreclosures due to borrowers who purposefully overstate their incomes and predatory lenders who intentionally inflate a borrower's income to increase their profit.

Today, many troubled loans are subprime hybrid ARMs, such as 2/28s and 3/27s, which allow borrowers to pay a low fixed interest rate for the first two or three years of the 30-year loan followed by regular interest rate adjustments for the remainder of the loan term. Homeowners with ARMs can experience significant "payment shock" after their interest rates adjust upwards, sometimes raising their monthly payments by as much as 40 percent. The new interest rate may be well over what the homeowner can comfortably afford, particularly in housing markets where home values have fallen or stagnated. Twenty-four percent of ARMs first originated in 2006 have negative home equity, which indicates that many of these homeowners are losing financial ground rather than building wealth.[12]

Borrowers

To help a lender determine borrowers' eligibility for a loan product and their likelihood of defaulting, the mortgage-lending industry classifies them into three categories based their credit history, rating, and income:

- **Prime** borrowers are deemed by lenders to be the most qualified borrowers based on credit worthiness and income. These borrowers are eligible for loans originated at the lowest interest rates.
- **Alternative-A** borrowers are those with unstable or unreliable incomes (e.g., business owners, doctors, lawyers, and others who are self-employed). Loans to Alternative-A borrowers carry a slightly higher interest rate than prime loans.
- **Subprime** borrowers have poor credit history, low incomes, or both and receive loans that carry the highest interest rates and may contain other fees and provisions designed to mitigate the lender's risk.

Today, subprime loans comprise just one-sixth of all mortgage loans but result in more than two-thirds of all foreclosures.[13] The subprime market has an important role in helping low-income families or those with blemished credit histories achieve homeownership. However, a combination of factors—rising interest rates, falling home values, economic hardship, lack of due diligence by borrowers and lenders, mortgage fraud, and predatory lending practices—has compounded, and many subprime borrowers have fallen behind on their mortgage payments. According to Freddie Mac, approximately one in 13 homes in the subprime market is at risk of foreclosure.[14]

Banks, Lenders, and Brokers

Several types of financial entities can originate mortgage loans in the United States, including national and state chartered banks; credit unions; thrifts, which take deposits and make residential and commercial loans; nonbank lending institutions; subsidiaries of banks and nonbank lenders; and mortgage brokers. The individuals who sit down with clients to negotiate and originate loans are loan originators who may work for either a mortgage broker or a mortgage lender. In some states, real estate agents also may act as loan originators. Less than one-third of all mortgage lenders are banks regulated by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), the National Credit Union Association (NCUA), the OCC, or the Office of Thrift Supervision (OTS).

Banks, which may be nationally or state chartered, are the most heavily regulated and examined mortgage lending entities in the United States and are subject to similar regulations whether they are state- or federally-chartered. Foreclosure poses a greater risk to banks than other lenders because banks assume the foreclosed property. When this happens, banks must dispose of foreclosed property, which becomes a liability on their books, generally at a financial loss. As a result, banks are more likely than other lenders to be willing to help borrowers find a way to avoid foreclosure.

Mortgage brokers—companies that act as a third-party liaison between a borrower and a lending institution—and nonbank lenders originate the majority of risky subprime loans. According to OTS, mortgage brokers originate between 70 and 80 percent of all subprime loans in the United States.[15] Mortgage brokers comprise about half of all mortgage lenders and are subject to various state regulations, but no federal regulations or licensing standards. Many licensed mortgage brokers are sole proprietors that act as loan originators. Other mortgage brokers are "net-branch" operations that allow individuals—who may or may not be individually licensed—to open branches by using the mortgage broker license of the parent company.[16] Some states do not require specific education or experience for loan originators whereas other states license mortgage broker offices but not loan originators.[17] Currently, 49 states license mortgage brokers and 35 license loan originators that are employed by mortgage brokers or lenders.[18]

In July 2007, the Conference of State Bank Supervisors (CSBS), a professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and the American Association of Residential Mortgage Regulators (AARMR) issued model guidelines for state mortgage regulators to use in examining lenders and brokers that offer nontraditional and subprime mortgages. Thirty-six states have adopted the nontraditional guidelines, and 29 states are working to adopt the subprime guidelines for upcoming examinations of state-licensed lenders. Additionally, beginning in January 2008, CSBS and AARMR will launch a nationwide mortgage licensing system to provide additional oversight of mortgage broker activity (see page 19).

Mortgage brokers work with borrowers by helping them to secure a loan with a lender. Brokers often work with several lenders and earn money by collecting fees from selling loans and preparing mortgage documents. Because brokers act as intermediaries who are not accountable for the long-term performance of a mortgage loan, they have an incentive to focus on the short-term profitability of a loan origination and make as many loans as possible. A 2003 study by AARP found that mortgage refinance loans originated by brokers to older borrowers were more than twice as likely to be subprime loans than were loans originated directly by lending institutions. Additionally, older borrowers with broker-originated loans were twice as likely to report that the broker initiated contact with them compared with borrowers with lender-originated loans.[19] These findings suggest that brokers, compared with lending institutions, are more aggressive in selling loan refinances and are more likely to seek out new borrowers.

The 50,000 nonbank lenders in the United States are overseen by the Federal Trade Commission (FTC). Nonbank lenders are financial institutions such as commercial financial companies, credit card companies, and insurance companies that do not hold depository accounts and include for-profit entities. These lenders do not undergo the same level of examinations required of banks. Because nonbank lenders are not subject to the same scrutiny as federally regulated depository institutions and can sell loans to the private secondary market, they too have an incentive to focus on short-term profitability.

Subprime Versus Predatory Lending

The emergence of the subprime lending industry has exacerbated mortgage fraud and predatory lending. It is important to emphasize that not all subprime lending is predatory, and predatory lending is only one component that is driving the rise of subprime foreclosures. However, predatory lending is much more common within the subprime loan market than the prime market.

Predatory lending activity is difficult to quantify because of the complexity of loans and the involvement of multiple parties including lenders, appraisers, and mortgage brokers. Though it may be challenging to isolate predatory practices, there are common indicators that suggest a loan is predatory (see box, below). Predatory loans are often high-interest, high-fee, and riddled with terms that strip the borrower of home equity. Lenders may fail to disclose egregious loan terms, misrepresent a loan, or execute a "bait-and-switch" where the terms of the loan at the closing are different from the terms the borrower originally approved. Predatory loans also may include products without the borrower's knowledge and ignore escrows for taxes and insurance, requiring borrowers to pay them in a lump sum. Additionally, some brokers or lenders may work with home appraisers and inspectors to inflate the value of the home in an effort to saddle a borrower with a larger loan. The loan originator will then provide kickbacks to the other parties involved in inflating the loan.

Common Earmarks of Predatory Loans

Yield-spread premiums give a bonus to brokers for assigning a borrower an interest rate for a mortgage loan that is above the rate for which the borrower is eligible.

Mandatory arbitration limits a borrower's right to contest abusive loan terms in the future.

Excessive fees significantly raise the price of loan origination and loan transactions.

Excessive/abusive prepayment penalties saddle a borrower with a large fine for paying or refinancing a loan before the maturation of the original loan. Not all prepayment penalties are abusive; however, characteristics of abuse include penalties that represent an excessively high percentage of the mortgage or that continue throughout the life of a loan.

A common predatory action is to put pressure on a borrower to refinance, or "flip," a loan repeatedly. Flipping helps the lender or broker collect additional fees, often while saddling the borrower with higher monthly payments.

Lenders and brokers also may sell exotic products, such as balloon loans and ARMs, to borrowers under the guise of traditional loans. An exotic loan that is otherwise legal may be considered predatory if a lender fails to consider a borrower's ability to repay the loan after monthly payments increase to their maximum amount or if the lender misrepresents or purposefully fails to disclose loan terms, such as maximum monthly payments and interest rate adjustments. When exotic loans are paired with abusive fees and penalties and other predatory tactics, the results can be devastating to a borrower.

For example, in testimony before Congress, FDIC Chairwoman Sheila C. Bair noted that subprime borrowers have a higher housing cost burden than prime borrowers. Whereas the average prime borrower spends approximately 17 percent of his or her net income on mortgage and other housing costs, the average subprime borrower spends nearly 37 percent of his or her net income on these expenses. This percentage is likely to increase as more subprime borrowers with ARMs see their rates adjust upwards.[20] When borrowers devote large percentages of their monthly incomes on housing costs, they must sacrifice spending in other areas such as food, clothing, and retirement. Therefore, when these subprime borrowers receive exotic loans as a result of predatory practices, they are especially likely to suffer serious financial consequences.

Predatory lenders often target specific neighborhoods, which helps to explain why foreclosures tend to be clustered together. A borrower who lives in a high-minority area is 35 percent more likely to receive a subprime loan with a prepayment penalty than a borrower who lives in a predominantly white neighborhood.[21] Predatory mortgage lenders tend to prey on low-income, minority, and elderly homeowners. In a 2006 analysis, CRL found that African Americans and Latinos were 29 percent and 40 percent more likely, respectively, to have high-cost subprime fixed-rate loans than white borrowers with similar characteristics.[22]

Other likely targets of predatory lenders include women, particularly single mothers and elderly women, and borrowers residing in rural communities. Rural borrowers are vulnerable to predatory lenders because fewer financial institutions serve rural areas than urban areas. Rural communities in the South and Midwest with high poverty and minority concentrations are the most likely to receive loans with high interest rates.[23]

Predatory Tactics

A May 2007 report from National Public Radio featured former employees of what was once the nation's largest subprime lender explaining the tactics they used to originate new and profitable loans. Loan originators described making overt misrepresentations of loan terms and concealing adjustable rates and prepayment penalties. Loan originators often used bait-and-switch tactics to trick clients into signing loan documents with abusive terms. One employee placed papers containing fixed interest rate terms at the top of a stack of loan papers at closing. Beneath those papers, were documents negating the fixed rate and installing an adjustable rate. In 2006, 49 state attorneys general won a lawsuit against the company, but the settlement funds are unlikely to bring much financial relief to the 240,000 victims.

Foreclosure's Impact on States, Neighborhoods, and Families

When a family loses its home, the loss devastates the family's financial stability and the repercussions ripple throughout the community, weakening neighborhood vitality and hurting the local economy. Foreclosed families lose their home and their home equity. They may face additional financial burdens such as fees, penalties, taxes on forgiven debt, and the costs associated with moving to a new location. Moreover, foreclosure ruins a borrower's credit, making it difficult to access and afford stable and safe housing. A 2004 study found that it can take whites 10.7 years, African-Americans 14.4 years, and Hispanics 14.3 years to purchase a new home after leaving homeownership.[24] Foreclosed borrowers are often forced to move in with family members or find landlords willing to rent to tenants with poor credit. Foreclosure may even force some former homeowners into homeless shelters.[25]

Renters are also affected by foreclosure. When an owner of a multi-family housing unit faces foreclosure, renters of that unit also may face an uncertain future. Officials of two counties in the Minneapolis, **Minnesota** area estimate that between 43 percent and 45 percent of their first quarter foreclosures in 2007 were rental properties.[26] The recent housing slump also has contributed to the number of developers at risk of foreclosure due to weak sales. In **North Carolina**, Governor Mike Easley signed a new law, HB 947, in August 2007 to protect tenants living in foreclosed properties, due to the increase in commercial foreclosures in the state.[27] The law requires that certain tenants receive notice of foreclosure proceedings and the opportunity to cancel rental agreements.

Foreclosure harms neighborhoods and communities in a variety of ways. In 2005, the Woodstock Institute found that each foreclosure in a neighborhood lowers the property value of surrounding homes by 0.9 to 1.136 percent on average.[28] A foreclosure in a low- to moderate-income neighborhood causes property values to drop even more. The more foreclosures that occur in a single neighborhood, the more surrounding property values decline. An April 2007 report from the U.S. Senate Joint Economic Committee estimates that a single foreclosure can cost as much as $80,000 in terms of loss to lenders, investors, and the community at large.[29]

Neighborhoods that experience multiple foreclosures face other consequences. Vacant homes often deteriorate due to lack of maintenance and can attract crime. Other homeowners have a difficult time selling their homes when they must compete against steeply discounted foreclosed homes sold or auctioned by banks. Additionally, municipalities, neighborhoods, and local schools lose revenue previously generated by property taxes and county service fees from water, gas, and electricity.

In one zip code in Detroit, **Michigan**, an estimated one in three subprime loans originated between 2002 and 2006 are now on the brink of or are already in foreclosure. In 2006, homeowners in that zip code took out more than $6 million in subprime loans, which comprised between 65 percent and 70 percent of the total number of loans originated in that zip code. As a result, neighborhoods experiencing a high number of foreclosures are starting to decline as troubled homeowners abandon their homes.[30] In **North Carolina**, more than 20 percent of homes have foreclosed in 35 starter home developments in Mecklenburg County, where overgrown lawns and empty houses have become common.[31]

State Actions to Address Foreclosures

In light of the recent wave of foreclosures, governors have launched initiatives aimed at helping troubled homeowners by blocking foreclosure rescue scams, connecting borrowers to counseling and resources, facilitating loan workouts and refinances, and slowing the foreclosure process to give homeowners time to save or sell their homes. States also have moved to prevent future foreclosure crises by banning predatory lending practices, tightening regulation of mortgage brokers and loan originators, criminalizing mortgage fraud, and educating homebuyers. The following sections provide an overview of the state role in mortgage market oversight and detail state actions to help troubled homeowners and prevent future foreclosures.

The State Role in Mortgage Market Oversight

States regulate nonbank lenders and mortgage brokers, which originate collectively more than 50 percent of all mortgage and refinance loans. Nonbank lenders are also overseen in part by FTC and HUD. The majority of subprime loans are made through nonbank lenders and brokers, and these loans have a higher failure rate than subprime loans originated through national- and state-chartered banks.

Federal laws such as the Home Ownership Equity Protection Act seek to ensure that lenders accurately represent loan products, and the Home Mortgage Disclosure Act requires lenders to submit data to the FDIC each year to help the federal government identify questionable lending practices. However, current oversight and regulation does not fully protect consumers from predatory lender as a result of the expansion of the subprime market, the rapid growth of mortgage broker and nonbank lending activity in recent years, and the proliferation of nontraditional and complex mortgage products. In response, states are strengthening statutes and regulations that govern mortgage brokers and certain nonbank lenders, although a recent Supreme Court decision upheld federal preemption over the state regulation of nonbank mortgage subsidiaries of nationally chartered banks.

The Impact of Watters v. Wachovia Bank, N.A.

In the 2006 Supreme Court case of *Watters v. Wachovia Bank, N.A.* {127 S. Ct. 1559 (2007)}, the Court held that federal banking law preempts certain state regulation of nonbank subsidiaries engaged in mortgage lending. The court's ruling hampers the ability of states to apply state laws governing examination, supervision, and regulation of mortgage lending to a nonbank operating subsidiary of a federally chartered bank.

States are well-suited to reach out to troubled borrowers to help connect them with the resources necessary to avoid foreclosure. Because states understand their own residents and the challenges they face, state policymakers can tailor initiatives to meet the needs of their citizens. This is particularly true in the area of mortgage finance regulation. In considering laws and regulation to prevent future foreclosures, state policymakers are well situated to strike an effective regulatory balance that protects homeowners without cutting off credit access to low-income borrowers who could benefit from homeownership.

Helping Troubled Homeowners

In congressional testimony, the chairman of Freddie Mac suggested that policymakers focus their efforts on low- and moderate-income and minority families, as these borrowers account for about half of all subprime borrowers and may be disproportionately hurt by the rising number of foreclosures.[32] Taxpayers are likely to balk at a broad bailout of troubled borrowers, and some borrowers may simply not be financially ready to sustain homeownership, even with state assistance. Some states are trying to focus their statutory and regulatory efforts only on those borrowers who were the victims of fraud or predatory practices.

As a critical first step, several states have launched task forces and investigations aimed at identifying the scope of the foreclosure crisis in their states. A task force can help to pinpoint the problem and develop useful recommendations for helping the families most at risk of losing their homes while creating solutions for preventing new foreclosures.

For example, in June 2007, **Maryland** Governor Martin O'Malley launched the Maryland Homeownership Preservation Task Force. It is charged with examining the subprime market in the state and creating recommendations for preventing future foreclosures. Specifically, the task force will gather data on the current state of housing in Maryland, including existing laws and regulations. The task force will use this information to create programs that minimize the number of foreclosures and develop outreach, counseling, and education to support homeowners and prevent future foreclosures. The task force also will evaluate financial resources to determine how best to assist families in need of workouts, refinances, and other financial assistance.[33]

New York Governor Eliot Spitzer launched a task force in May 2007 that similarly aims to identify communities at risk of multiple foreclosures, develop financial assistance programs to aid troubled borrowers, and launch a statewide outreach and education campaign. The task force also is charged with proposing legislative and regulatory reforms to strengthen consumer protections and creating a system to better identify predatory lenders and ensure that those lenders are pursued by law enforcement.[34]

Other governors, including **Arizona** Governor Janet Napolitano, **Connecticut** Governor Jodi Rell, and **New Mexico** Governor Bill Richardson created similar task forces to serve as starting points for identifying the extent of subprime foreclosures in their states and recommending strategies for keeping families in their homes.[35] **Indiana's** general assembly has created an interim study committee to address mortgage lending and foreclosure issues.[36] **Michigan** Governor Jennifer Granholm has directed the Michigan Office of Financial and Insurance Services and the Michigan State Housing Development Authority to examine the current problems facing consumers with subprime loans and develop initiatives to improve industry oversight and assist borrowers who are facing foreclosure.[37] **Ohio** Governor Ted Strickland's foreclosure task force, created in March 2007, released findings September 2007, which include recommendations on:

- Encouraging borrowers to get help early;
- Expanding housing counseling and intervention services;
- Working with lenders and servicers to maximize foreclosure alternatives;
- Providing loan refinance and restructure options to homeowners, including tax forgiveness on loan readjustments;
- Improving the foreclosure process by increasing borrower access to legal counsel, encouraging dispute resolution, and expediting property transfer; and
- Helping communities recover from foreclosure.[38]

Once a state has decided that action is needed, there are several options available for assisting troubled borrowers, including:

- Stopping foreclosure scams;
- Connecting borrowers to counseling and resources;
- Encouraging workouts and refinances; and
- Slowing the foreclosure process.

Stopping Foreclosure Scams

States have seen a rise in foreclosure rescue scams, where people purporting to help troubled homeowners trick them into relinquishing their titles or selling at a price lower than they would receive on the market. Victims of foreclosure rescue scams—often the same people susceptible to predatory lenders—lose even more than they would under normal foreclosure circumstances. State laws to protect homeowners from such fraudulent activity can help to prevent scammers from exacerbating the already difficult and costly process of foreclosure.

For example, **Illinois** passed the Mortgage Rescue Fraud Act (SB 2349) in June 2006 to protect troubled borrowers from fraudulent foreclosure rescue scams. The law requires that any person who seeks to assist a homeowner at risk of foreclosure fully disclose in writing the terms of services and all associated costs. The law also gives troubled homeowners the option to cancel services with a mortgage rescuer at any time. The law aims to require mortgage rescuers to fulfill their obligation or purchase the homeowner's home for a high percentage of the home's value.

In July 2007, **New Hampshire** Governor John Lynch signed legislation that regulates foreclosure rescuers and establishes criminal and civil penalties for scammers.[39] HB 365 requires that foreclosure consultants provide homeowners a written contract fully disclosing the terms of any foreclosure rescue agreement and including associated fees. The document must be signed by both the homeowner and the consultant and be notarized. Additionally, the contract must include a document explaining the homeowner's right to cancel the agreement. The law also prohibits foreclosure rescuers from gaining power of attorney from a homeowner.

Indiana SB 0390, signed into law in May 2007, establishes new foreclosure notice requirements and protects homeowners from foreclosure rescuers by giving homeowners the ability to rescind contracts with foreclosure rescuers. The legislation further requires the Indiana Housing & Community Development Authority (IHCDA) to maintain a list of nonprofit, certified foreclosure consultants and forward this list to the attorney general on a regular basis.

Connecting Borrowers to Counseling and Resources

Foreclosure counseling can help troubled homeowners to understand their options and take action to save their homes before it is too late. Additionally, counseling can help connect borrowers to resources they need to restructure or refinance their existing loans or manage foreclosure if foreclosure is inevitable. **Indiana** Governor Mitch Daniels signed HB 1753 in May 2007 to provide free mortgage foreclosure counseling and education to troubled homeowners. Under the bill, the state gives the Indiana Housing and Community Development Authority (IHCDA) the option to establish a statewide mortgage foreclosure hotline to help connect homeowners to trained counselors. Additionally, homeowners in the state who receive a foreclosure notice will also receive information on foreclosure prevention resources available to them through IHCDA.

Several states have developed initiatives to help link homeowners to counseling and resources. Foreclosure hotlines, operated by states and nonprofits, have emerged as an effective way to provide troubled borrowers with the help they need. For example, **Colorado** launched a foreclosure prevention hotline in October 2006 through a joint effort by the state and industry and community groups.[40] The hotline connects at-risk borrowers to a local housing counseling agency so they can receive professional advice about avoiding foreclosure. According to the Colorado Division of Housing and Brother's Redevelopment Inc., as of April 2007 approximately four of five callers had avoided foreclosure.[41] Similarly, **Connecticut** Governor Jodi Rell has established a mortgage foreclosure assistance hotline for state residents facing foreclosure. Callers receive advice, guidance, information, and materials to help them address their mortgage problems.[42] States, such as **Delaware**, are also referring troubled borrowers to the Homeownership Preservation Foundation's national Homeowner's HOPE Hotline, 800-995-HOPE, for financial counseling.[43]

Outreach is an important component of ensuring that troubled homeowners receive help. According to the NeighborWorks America, many families wait until they have missed several payments before seeking help. In fact, in 2006, 62 percent of callers to a national foreclosure-prevention hotline were already more than two months behind on their mortgage payments.[44] By then, it is more difficult to work out a solution between the borrower and the lender. Lending institutions, community organizations, and federal bank regulators have urged borrowers to contact their loan servicers as soon as they begin having difficulty making payments. Governors can help lead this charge by targeting outreach toward communities most at risk of multiple foreclosures. As previously noted, **Maryland** and **New York** have charged their task forces with developing outreach campaigns.

NeighborWorks America, in partnership with the Ad Council, has launched a national advertising campaign to raise consumer awareness about rising foreclosures. The campaign urges borrowers that may have trouble paying their mortgage loans when their interest rates reset to contact the national HOPE hotline for free foreclosure prevention counseling. The campaign will work with state and local governments to tailor and target ads to particular communities, and keeps a list of localized print ads by state. Television, print, radio, and online advertisements are available to view and order on the campaign website.

Encouraging Workouts and Refinances

The most desirable outcome for all parties involved in a troubled loan is to avoid foreclosure and the associated costs and consequences. Policymakers may find that local and state banks, which suffer in terms of lost time and money when their borrowers enter foreclosure, are natural partners in developing efforts to help families stave off foreclosure. Particularly in the current climate of restricted credit access as a result of market response to subprime defaults, states are facilitating foreclosure solutions by doing the following:

- Asking troubled borrowers to contact their loan servicers;
- Encouraging lenders and loan servicers to work with troubled borrowers; and
- Offering financial assistance to at-risk homeowners to help them refinance out of high-cost loans with prepayment penalties or originate safe home refinance loans to borrowers through a state loan program.

Loan workouts allow borrowers to adjust the terms of their mortgage loans to make the loans more affordable. For example, some borrowers may need to extend the life of their loans from 15 years to 30 years or from 30 years to 40 years. Lenders also may agree to forgive part of the interest due or waive certain fees or penalties that resulted as part of the initial delinquency; however, forgiven debt can be a tax liability for the borrower (see paragraph on "Short Sales," page 16). A significant barrier to loan workouts is the securitization process. Some loan pools in the secondary market limit the percent of bonds within that pool that may be modified. As such, borrowers and foreclosure counselors may have a difficult time negotiating a workout.

Refinancing is another way to help borrowers escape troubled loans. For a borrower holding a loan with an unaffordable interest rate or one that contains equity-stripping fees and penalties, refinancing may be the best solution to help the borrower obtain a loan with safe and affordable terms. However, refinancing has become difficult for subprime borrowers because of recently tightened loan restrictions that preclude borrowers with poor credit history and loan delinquencies from gaining access to new credit.

Encouraging Troubled Borrowers to Contact Their Loan Servicers—States have several options for helping borrowers obtain loan workouts and refinances. First, states can encourage borrowers to contact their loan servicers. A loan servicer is a company that collects, manages, and reports loan payments after the loan has been approved and dispersed. Lenders that originate loans and investment banks that purchase loans in the secondary market typically hire a loan servicing company to manage the loan and work with the borrower. In **Montana**, the Montana Board of Housing provides funding for foreclosure prevention counseling to help borrowers negotiate with loan servicers by evaluating options such as working out an agreement with the loan servicing company, analyzing assets that may be used to bring a loan current, budgeting, or arranging a short sale or deed in lieu of foreclosure.[45]

Second, states may refer borrowers to Fannie Mae and Freddie Mac for assistance with loans these GSEs have purchased or guarantee. Fannie Mae and Freddie Mac then direct servicers to engage in loss mitigation efforts and workouts. Although the GSEs function mainly in the prime mortgage market, Freddie Mac has announced a $20 billion commitment to purchase subprime mortgages with a product designed to limit payment shock by offering reduced adjustable rate margins, longer fixed-rate terms, and longer reset periods.[46] The combined efforts of Freddie Mac, Fannie Mae, and the Federal Housing Administration (FHA) could provide relief for an estimated 50 percent of borrowers with troubled loans.[47] States can encourage borrowers to determine whether they are eligible for a workout through Fannie Mae or Freddie Mac or can refinance with an FHA-insured loan.

Encouraging Lenders and Loan Servicers to Work with Troubled Borrowers—Governors can encourage lenders and loan servicers to work with borrowers to keep them in their homes. For, example, in April 2007, **Massachusetts** Governor Deval Patrick encouraged state banking officials to renegotiate mortgage terms to help troubled borrowers stay in their homes.[48] On September 5, 2007, **California** issued a notice to loan servicers subject to California law, encouraging them to work with financially stressed borrowers to provide loan workouts. Workout arrangements may include modified loan terms or converted loan products with payments that are easier for the borrower to manage. The notice also encourages servicers to contact at-risk borrowers early to determine their risk of loan default.[49]

In September 2007, attorneys general from 10 states announced the formation of a task force to encourage loan servicers to provide workouts for troubled borrowers. The task force, which includes representatives from **Arizona**, **California**, **Colorado**, **Illinois**, **Iowa**, **Massachusetts**, **New York**, **North Carolina**, **Ohio**, and **Texas**, has invited mortgage servicing companies to collaborate on finding ways to help subprime borrowers obtain workouts and creating long-term solutions for troubled borrowers.[50]

States also can encourage lenders to allow "short sales" to help borrowers for whom foreclosure is inevitable cut their losses and keep their credit intact. Through a short sale, borrowers who owe more on a mortgage loan than their home is worth may sell their homes for whatever they are worth on the market. The lender in turn accepts the amount of the sale as payment in full for the loan. However, states are finding that short sales have tax implications due to the debt that the lender forgives. Currently, the forgiven debt is treated as income and is subject to income tax, which can result in a large tax bill for the former homeowner. On the other hand, through a short sale, the borrower avoids having a foreclosure appear on his or her credit report, which makes it easier to find safe and decent housing after the sale of the home. Borrowers considering short sales must therefore consider the pros and cons of such a transaction.

Offering Financial Assistance to At-Risk Borrowers—States are developing financial programs to help borrowers avoid foreclosure. For example, **Ohio** has launched the Opportunity Loan Refinance Program to help borrowers refinance high-cost mortgages. In April 2007, the state announced that it would sell up to $100 million of taxable bonds to make new home loans to eligible borrowers. Eventually, the state may sell up to $500 million in bonds. Mortgage payments will pay off the bonds. The Opportunity Loan Refinance Program website lists approved lenders that borrowers can use to start the refinancing process. The program targets borrowers with high-cost subprime loans, particularly subprime ARMs, and helps them refinance to a lower-interest fixed-rate loan before they become delinquent on their mortgage payments. Families with up to 125 percent of the area median income may apply for the program. The program has no maximum loan amount or appraisal value, but it does require a new home appraisal before refinancing. The loans cover up to 100 percent of the appraisal value, and borrowers may also receive a second mortgage for up to 4 percent of the appraisal value to cover closing costs and any prepayment penalty attached to the original loan. The Ohio Housing Finance Agency also works with Fannie Mae to secure underwriting waivers that help to qualify some borrowers who would otherwise be ineligible for a traditional mortgage loan refinance.

Similarly, **Maryland** borrowers can take advantage of "Lifeline" Refinance Mortgage Program, a program launched in 2006 that allows homeowners saddled with rising adjustable interest rates to refinance their loans through one of the approved lenders listed on Maryland's Department of Housing and Community Development website. The state also is working with lenders to find alternatives to prepayment penalties for borrowers seeking to refinance. Once a borrower refinances into a new loan, the lender bundles that loan with others and sells the loan package to the Maryland Department of Housing and Community Development, which makes the purchase using cash from a bond issue. Borrower interest on the new loans will go to the state for paying off the bonds. Borrower eligibility is determined by maximum household income limits, maximum appraised value limits, loan-to-value limits, and credit limits. Borrowers with credit scores below 600 may not be approved for a loan but are not automatically disqualified.

Additionally, borrowers with credit scores below 680 are required to go to homeownership counseling.

In July 2007, **New York** launched a similar foreclosure prevention fund. New York's Keep the Dream fund sets aside $100 million to help between 500 and 700 families refinance out of high-risk loans.[51] As part of their participation in the program, borrowers must take a homeowner education course prior to loan origination and participate in early delinquency intervention counseling should they get behind on payments to their refinanced mortgage. Also in July, **Massachusetts** created a $250 million foreclosure prevention fund with the help of $190 million from Fannie Mae. The remaining cost of the program is covered by a $60 million sale of bonds. The program targets low-income victims of predatory lending and will accept borrowers who are up to 60 days delinquent on their mortgages if the cause of their delinquency is an interest-rate reset. **Delaware's** Emergency Mortgage Assistance Program (DEMAP), **Pennsylvania's** Refinance to an Affordable Loan (REAL) Program, and **Montana's** HomeOwnership Network offer similar services to borrowers at risk of foreclosure.

In 2006, **Michigan** Governor Jennifer Granholm announced that the Michigan State Housing Development Authority and the Mortgage Guaranty Insurance Corporation would provide lower mortgage insurance premiums and payment assistance to eligible borrowers who become involuntarily unemployed. This program provides up to $1,500 or the total amount of the mortgage payment, whichever is less, for a period of up to six months to help troubled borrowers avoid foreclosure.[52]

Slowing the Foreclosure Process

To slow the wave of foreclosures, some states are considering moratoriums on current foreclosures or waiting periods on future foreclosures. For instance, in April, **Massachusetts** Governor Deval Patrick launched a 60- to 90-day delay on certain foreclosure proceedings.[53] He directed the Massachusetts Division of Banks to work on a case-by-case basis to delay for up to two months foreclosures on borrowers who have filed consumer complaints. This waiting period gives borrowers time to settle their debts, seek a loan workout, or sell their property, thus mitigating the financial damage of foreclosure. **Louisiana** Governor Kathleen Babineaux Blanco has encouraged lenders either to wait before initiating foreclosure on borrowers or pursue other options.

Foreclosure moratoriums have potential downsides that states may want to consider. Some housing experts argue that delaying foreclosure can be problematic because the foreclosure process is already lengthy, lasting anywhere from 30 days to 19 months depending on state law, and typically does not begin until loans are 60 to 120 days delinquent. Therefore, further delay may be costly to borrowers because a borrower's debt continues to accumulate if he or she is unable to obtain a workout, sell the home, or repay the debt. Finally, delays increase the time that properties stay vacant, which can have a negative impact on the value of surrounding homes.

Preventing Future Foreclosures

In addition to helping borrowers in danger of losing their homes, governors have focused attention on the laws and regulations surrounding the mortgage lending market that left the door open for predatory lending and mortgage fraud. As a result, many states have passed legislation aimed at:

- Banning predatory lending practices;
- Adopting regulatory guidelines for subprime and nontraditional mortgage products;
- Tightening regulation of mortgage brokers and loan originators;
- Increasing criminal penalties for mortgage fraud, enforcing existing lending laws, increasing funding for supervision, and pursuing violators; and
- Educating homeowners.

Banning Predatory Lending Practices

Currently, more than 30 states have some form of an antipredatory lending law, and many other states are considering similar laws. For instance, many states ban abusive prepayment penalties, which can prevent borrowers from refinancing out of failing mortgage loans. However, some states are finding that their laws do not cover all of the practices that are trapping borrowers in failing loans today. In seeking to curb predatory lending, it is important that states strike a careful balance between stopping bad lending practices and ensuring that lenders still have the ability to use financial tools that could be beneficial for offering credit to low-income borrowers and those with less than stellar credit.

In response, several states have passed new legislation designed to curb predatory lending practices. For example, in August 2007, Governor Mike Easley signed new legislation to strengthen **North Carolina**'s antipredatory lending law.[54] In 1999, the state adopted the country's first antipredatory lending law, but rapid changes in the lending market since the adoption of that law prompted the state to add additional consumer protection from abusive lenders. HB 1817:

- Limits mortgage brokers' ability to collect yield-spread premiums and charge prepayment penalties;
- Requires lenders to consider the ability of borrowers to repay the loans; and
- Protects homeowners from abusive mortgage servicing companies that misapply mortgage payments, charge illegal fees, and mishandle escrow accounts.

On June 11, 2007, Governor John Baldacci of **Maine** signed LD 1869 to protect Maine homeowners from predatory lending.[55] The legislation, which received bipartisan support as well as support from local consumer and professional organizations, prohibits mortgage loans from accelerating the homeowner's debt, such as through negative amortization (i.e., when mortgage debt increases because the homeowner is not required or not permitted to make full payments on interest and principal) and bans mandatory arbitration clauses. The legislation also bans loan flipping, caps lender fees, and requires lenders to consider a borrower's ability to repay a loan prior to origination. The bill additionally mandates homeownership counseling for subprime borrowers.

On May 14, 2007, **Minnesota** Governor Tim Pawlenty signed SF 988 to strengthen consumer protections against predatory lending practices. The legislation gives borrowers recourse to bring suit against predatory lenders and collect attorney's fees if they win their suit. Specific provisions of the bill require lenders to originate adjustable loans only if the borrower can afford the adjusted rate. The law also caps loan fees, bans negative amortization, prohibits prepayment penalties, requires lenders to include escrow in stating the cost of a loan to a borrower, and bans loan flipping. Additionally, the legislation prohibits the refinancing of a "special mortgage"—a mortgage with a nonstandard payment terms, such as income-based payments or no- or low-interest, that is provided, serviced, or subsidized by state, local, or tribal government or a nonprofit organization—unless special loan counselors certify that they counseled the borrower on the advisability of refinancing.

In May 2007, **Hawaii** Governor Linda Lingle signed three pieces of legislation (SB 1400, HB 1306, and HB 1336) designed to give specific protections to the state's senior citizens against solicitations for fraudulent mortgage investments.[56] The new laws require financial institutions to report immediately suspected fraudulent activity against customers ages 62 or older; create additional penalties against people convicted of securities violations against customers ages 62 or older; and levy additional fines on mortgage brokers who enter into mortgage agreements with senior citizens resulting in loss home equity or in the loss of their homes altogether.

In July 2006, **Rhode Island** Governor Don Carcieri signed the Home Loan Protection Act (S 2851) to better protect borrowers from predatory mortgage lending practices and the Madeline Walker Act (S 2092) to prevent foreclosure over small tax debts and enact other measures to improve regulations on the mortgage foreclosure industry. The Home Loan Protection Act prohibits loan flipping and mandatory arbitration and attempts to eliminate incentives for lenders to make predatory loans by creating "assignee liability" for secondary parties that purchase high-cost home loans. In June 2007, the state legislature clarified the assignee liability provision to ensure that only borrowers acting in an individual capacity may assert a claim against the assignee. Assignee liability makes the loan purchaser liable if the borrower brings suit against the original creditor. By making the secondary purchaser liable for borrower claims, the secondary purchaser has an incentive to ensure that the loans it buys comply with the law, which shifts market demand to safe and affordable loans. The act also gives families access to mortgage counseling and education.

Ohio's Homebuyer Protection Act (SB 185), passed in June 2006, prohibits mortgage loan originators, mortgage brokers, and nonbank lenders from engaging in unfair and deceptive lending practices. The Homebuyer Protection Act bans:

- Originating a loan knowing that the borrower will not be able to repay;
- Repeatedly refinancing a loan when there is no benefit for the borrower;
- Taking advantage of illiterate borrowers and borrowers with mental deficiencies;
- Financing credit, life, disability, or unemployment insurance premiums or any debt collection agreements as part of a loan, unless those premiums are paid monthly;
- Charging multiple late fees on a single late payment; and
- Enforcing a prepayment penalty on first lien mortgages of less than $75,000.[57]

Adopting Regulatory Guidelines for Subprime and Nontraditional Mortgage Products

Many states are working to adopt regulatory guidelines for mortgage brokers and mortgage companies not affiliated with a bank holding company or insured financial institution. In July 2006, CSBS and AARMR developed guidance to assist state regulators in clarifying how mortgage brokers and state-regulated mortgage companies can offer nontraditional mortgage products in a way that ensures borrowers understand the risks associated with these products.[58] On June 29, 2007, CSBS, AARMR, and the National Association of Consumer Credit Administrators (NACCA) issued a Subprime Statement to clarify how mortgage brokers and state-regulated mortgage companies can offer subprime loans in a way that clearly discloses to borrowers the risks they may assume by using such products.[59] The goal of the nontraditional mortgage guidance and the subprime statement is to help state regulators promote consistent regulation of the mortgage market. The guidance parallels nontraditional mortgage guidance and a subprime statement issued by the OCC, FRB, FDIC, OTS, and NCUA in October 2006 and June 2007.

Additionally, in July 2007, CSBS and AARMR issued model guidelines for state mortgage regulators to use in examining lenders and brokers that offer nontraditional and subprime mortgages.[60] Since 2006, 36 states have adopted the nontraditional guidelines, and 29 states are working to adopt the subprime guidelines for upcoming examinations of state-licensed lenders.

Tightening Regulation of Mortgage Brokers and Loan Originators

States are implementing licensing standards for individual loan originators that include education requirements, testing, and criminal background checks. Currently, 35 states require licensing or registration of individual loan originators. States also are enacting rules that place a fiduciary responsibility on individual loan originators to act in the best interest of the borrower.

Moreover, states are seeking to impose regulations on brokers, lenders, and loan originators by requiring strict licensing standards and working with other states to ensure that companies and individuals that have engaged in fraudulent activity in the past cannot relocate to a new state and continue such activity. To aid this effort, CSBS has been working with AARMR to develop a national mortgage licensing system. The goal of this initiative is to increase the efficiency and effectiveness of the mortgage market by improving supervision and accountability of mortgage lending professionals. As of July 2007, 35 states had announced their intent to participate in the licensing system, which will launch in January 2008. The system will allow consumers to access information on licensed brokers, lenders, bankers, and mortgage companies, including license status and a history of public enforcement actions. The system will assign each loan originator a unique identifier that can be used to track companies and people across states over time.

To prevent fraudulent lending activity in her state, in July 2007, **Alaska** Governor Sarah Palin signed legislation to require background checks, licensing, and competency testing of mortgage lenders, brokers, and originators. HB 162 will become active on March 1, 2009, and will be the first Alaskan law to regulate the lending industry. The bill's aim is to curb predatory lending by increasing lender accountability and preventing lenders, brokers, and loan originators who have engaged in predatory practices in other states from practicing in Alaska.

On June 1, 2007, **Colorado** Governor Bill Ritter signed a package of legislation aimed at curbing the 37,000 foreclosures the state expects to see by the end of 2007.[61] The legislation, which includes HB 1322, SB 85, SB 203, SB 216, and SB 249, primarily focuses on increasing mortgage broker regulation and oversight and includes provisions for the following:

- Expanding individual mortgage broker loan originator registration requirements;
- Preventing mortgage broker loan originators from influencing the judgment of a real estate appraiser in an effort to inflate the value of a house or property;
- Requiring that mortgage broker loan originators be licensed and adhere to specific training, testing, and education guidelines;

- Prohibiting mortgage broker loan originators from engaging in specific activities, including fraud and misrepresentation, and revoking licenses from brokers who violate these rules;
- Imposing a statutory duty of good faith and fair dealing upon mortgage broker loan originators; and
- Directing the Colorado Division of Insurance to provide a statistical report of trends within the state's mortgage market and complaints against mortgage broker loan originators.

In June 2007, **Florida** Governor Charlie Crist signed SB 1824 to strengthen regulations on mortgage brokers and individual loan originators, including new education requirements and fines for loan originators that engage in fraudulent lending activity. Under the new law, mortgage brokerages must provide consumers full disclosure of all parties involved in the mortgage, and the state's Office of Federal Regulation is fully authorized to enforce consumer protections with regard to mortgages.

In April 2007, **Minnesota** Governor Tim Pawlenty signed SF 809 to require mortgage brokers to act in a borrower's best interest. The legislation tightens broker regulations, including prohibiting mortgage brokers from unreasonably delaying the processing of a mortgage loan application or closing; misleading borrowers or misrepresenting the terms or a loan; working with home appraisers to inflate the value of a home appraisal; making a loan with the intent that the borrower will be unable to repay; and originating a subprime loan to a borrower who qualifies for a prime loan.

Increasing Criminal Penalties for Mortgage Fraud and Pursuing Violators
Providing the funding and staff resources necessary to provide regulatory oversight, enforce lending laws, and pursue violators is key to reducing fraudulent lending practices and protecting homeowners. For example, **New York** has updated assessment of mortgage brokers to provide sufficient funding resources for regulatory supervision. **Washington** implemented a law to provide a steady stream of funds for investigating and prosecuting mortgage fraud by adding an additional fee of $1 to every real estate recording. Collected fees are forwarded to a special agency fund, which is earmarked for the prosecution of mortgage fraud. The fund accumulates approximately $1 million per year.[62] **Massachusetts** has significantly increased the number of examiners and consumer assistance specialists to improve supervision.[63] **Pennsylvania** has doubled the number of examiners who focus on nonbank lenders and mortgage brokers.[64]

Other states have passed legislation to improve enforcement of state lending laws. In **Illinois**, Governor Rod Blagojevich combined four state agencies to improve the enforcement of mortgage lending laws from start to finish. The consolidated agency, the Illinois Department of Financial and Professional Regulation, pursues lenders as well as realtors and others involved in the mortgage origination process through the state's Mortgage Fraud Task Force. The Mortgage Fraud Task Force has successfully disciplined more than 90 companies and individuals, with actions ranging from fines to revoking a company's license to do business in Illinois. Recently, the task force uncovered one of the largest fraud schemes in state history, "Operation Flip-Flop." The scheme centered in the Chicago area and involved more than 100 properties.[65] In **Ohio**, the Homebuyer Protection Act gives the state's attorney general enforcement authority over abusive lending practices committed by loan originators, mortgage brokers, and nonbank lenders.[66] The

California Department of Corporations (DOC) has a long history of taking action against predatory lenders. Specifically, the DOC has worked to oversee mortgage lenders and pursue those that engage in fraudulent activity. If a lending company unexpectedly closes, the DOC takes steps to ensure that loan holders are protected by gathering information about pending loans and consumer complaints, communicating with consumers, investigating the company's activities, examining circumstances surrounding the closure, and taking enforcement action if deemed necessary.[67]

Developing a systematic way to spot potentially predatory activity as well as locating patterns of fraudulent activity among brokers and lenders is vital to curbing predatory lending and protecting homeowners. For example, **Illinois** has launched a predatory lending database to track the activities of lenders in the Chicago area, enabling quicker identification of potentially questionable lending practices.[68] **Colorado's** new predatory lending legislation attempts to improve efforts to locate predatory lending activity through statistical reports to be produced by the Colorado Division of Insurance.[69]

Some states also are working to ensure that borrowers have the ability to pursue fraudulent lenders in court and seek retribution as victims of predatory lending. Because many predatory loans include mandatory arbitration terms that restrict borrowers' ability to bring suit against lenders if the terms of the loan are found to be unfair or misrepresented, **Minnesota** Governor Tim Pawlenty signed legislation giving borrowers recourse to bring suit against predatory lenders and collect attorney's fees if they win their suit.[70] **Maine**'s homeownership protection law bans mandatory arbitration clauses.[71] **North Carolina** passed new legislation in August 2007 to clarify state Supreme Court decisions that made it difficult for borrowers to sue over illegal lending practices. HB 1374 makes it easier for borrowers to get recourse against predatory lenders.[72]

Additionally, some states have increased criminal penalties for mortgage fraud by allowing state prosecutors to bring criminal charges against those suspected of predatory lending. For example, in June 2007, **Arizona** Governor Janet Napolitano signed HB 2040 to make mortgage fraud a class four felony and a pattern of mortgage fraud a class two felony. **Massachusetts** Governor Deval Patrick has proposed legislation that would define mortgage fraud and create criminal penalties for violations.[73] Currently, authorities may file civil charges against those suspected of mortgage fraud in the state. Under the proposed legislation, the state's attorney general would pursue criminal prosecutions of mortgage fraud. **New Hampshire's** legislation to protect homeowners against mortgage rescue scams makes violation of the law a violation of the Consumer Protection Act, and penalties include fines, jail time, and repayment of equity to the homeowner.[74] Complaints are pursued by the state's banking department.

Educating Homebuyers

Many policymakers cite financial education for potential homeowners as a key component of preventing predatory lending and foreclosure by empowering people to take personal responsibility, avoid predatory loans, and make good financial decisions. Many cities already require first-time homebuyers to undergo prepurchase counseling, and several state and local governments offer homebuyers the opportunity to access no- or low-cost financial education. For example, **Virginia** Governor Tim Kaine signed HB 2513 in February 2007 to allow life skills programs at public colleges and universities to educate students about savings and investments, predatory lending practices and interest rates, consumer fraud, and identity theft and protection.

The **Michigan** Office of Financial and Insurance Services has established a consumer education outreach program to provide consumer and community groups with resources on financial services, scams, and investments.[75] Recent foreclosure legislation from other states such as **Maine**, **Maryland**, **Minnesota**, **New York**, and **Rhode Island** also includes financial education components for troubled borrowers.

In **Montana**, the Montana Board of Housing (MBOH) promotes homebuyer education and individual homeownership planning across the state by providing funding to the 24 partners of the Montana HomeOwnership Network. The homebuyer education program stresses the importance of shopping for the best mortgage terms, while individual homeownership planning helps borrowers improve their credit reports so they can qualify for prime mortgages. Since 1998, more than 12,000 Montanans have completed homebuyer education.

The **Illinois** legislature passed SB 1167 on August 7, 2007, to require homeownership counseling for residents in the Chicago area who wish to obtain a nontraditional mortgage loan. The goal of the legislation is to reduce foreclosures by educating homebuyers. The legislation would require brokers and lenders originating loans in the Chicago area to submit loan information to the state's predatory lending database, after which the Department of Financial and Professional Regulation would determine whether the borrower should receive homeownership counseling, administered by a HUD-certified counseling agency. Originators would fund counseling and would be required to submit documentation that the borrower completed counseling prior to loan origination.

Several other states use Freddie Mac's Don't Borrow Trouble campaign to educate borrowers about the dangers of predatory lending. Don't Borrow Trouble combines consumer outreach with education and counseling to give people the tools they need to avoid being deceived by a predatory lender. **Alaska**, **Connecticut**, **Delaware**, **Kentucky**, **Minnesota**, **Mississippi**, **New Mexico**, **North Carolina**, and **Rhode Island** already have statewide campaigns, as do communities within 20 other states. Because the Don't Borrow Trouble campaign already has several marketing materials and resources for consumers, it is a good tool for states wishing to educate consumers about predatory lending quickly.

Conclusion

States across the country have been feeling the pinch of the growing number of foreclosures. In response, many states are helping troubled borrowers and working to prevent future foreclosures. Facing the possibility that millions of additional households could enter foreclosure, governors are exploring new options to keep families in their homes and protect homeowners.

Current approaches to helping troubled borrowers include:

- Protecting consumers from foreclosure "rescue" scams;
- Connecting borrowers to counseling and resources;
- Encouraging workouts and refinances by working with loan servicers and establishing foreclosure prevention funds; and
- Slowing the foreclosure process.

At the same time, states also are working to prevent future foreclosures by taking steps to reduce predatory lending practices, including:

- Banning common predatory practices;
- Adopting regulatory guidelines for subprime and nontraditional mortgage products;
- Tightening regulation of mortgage brokers and loan originators;
- Increasing criminal penalties for mortgage fraud, enforcing existing lending laws, increasing funding for supervision, and pursuing violators; and
- Educating homebuyers.

States have a long history governing mortgage lending and foreclosure practices through statute and regulation. As foreclosures rise, states are writing new chapters in this history through tough legislation that aims to keep families in their homes, protect potential borrowers from predatory lenders, educate future homeowners, and preserve access to homeownership.

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